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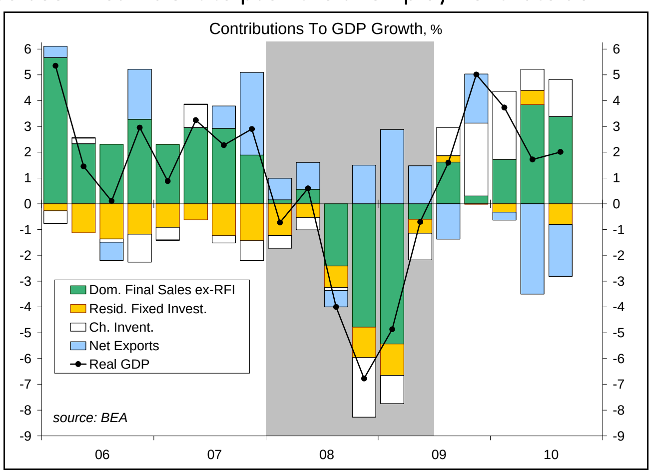
Monthly Economic Outlook

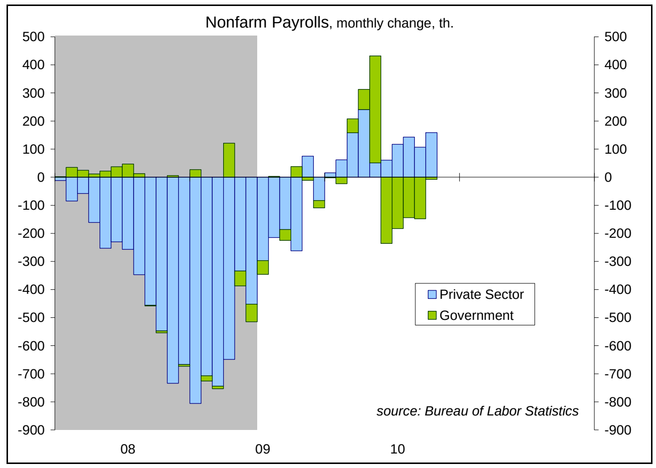
The Fed Acts, Critics Respond

- *Recent data continue to suggest moderate growth in the near term, not enough to push the unemployment rate down.*
- *Core inflation has continued to trend lower and is expected to remain mild for some time, a consequence of a high degree of excess capacity within the economy.*
- *The Fed's November 3 decision to increase its asset purchases was met with widespread criticism. As with any decision to ease monetary policy, there are plusses and minuses, but the benefits outweigh the risks and the consequences of not acting would likely be severe.*

Real GDP rose at a 2.0% annual rate in the government's advance estimate for 3Q10. That estimate is expected to be revised higher, but (as with the 2Q10 growth estimate) it's better than it looks. Higher inventories subtracted considerably from GDP growth in the last two quarters. Consumer spending growth was moderately strong and business fixed investment continued to expand. The summer "slow patch" in growth wasn't particularly slow. Still, the pace has been insufficient to push the unemployment rate down.



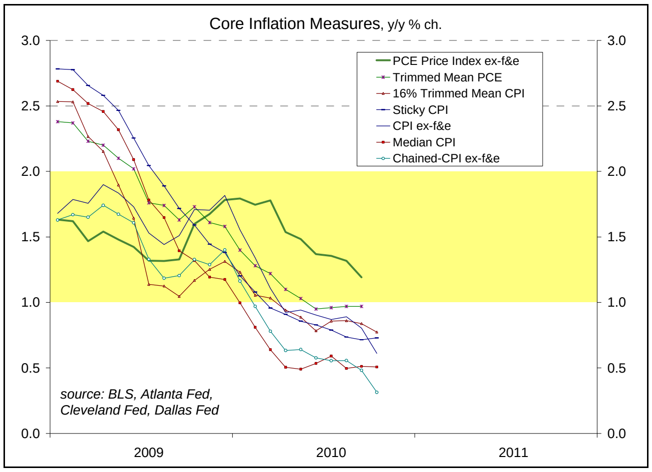
The broad range of economic data suggest a continuation of moderate growth in the near term. The economy continues to face the same headwinds: lingering problems in residential real estate, tight credit for consumers and small firms, contractionary policies in state and local governments. Fiscal policy is set to tighten in 2011 as the federal stimulus begins to wind down. Following the mid-term elections, the consensus is that all of the Bush tax cuts will likely be extended another two years. However, that's not a done deal. Raising taxes in a soft recovery is a bad idea, but there's also a strong desire (on the part of the public) to reduce the federal budget deficit. Extended unemployment benefits (set to expire at the end of November) are also likely to be an issue. Certainly, there are some deadbeats abusing the system, but many families rely on those benefits for food and shelter. As stimulus, extended unemployment insurance benefits provide relatively good bang for the buck. That is, these kinds of expenditures tend to get spent back into the economy right away and with a multiplier effect. Eliminating extended unemployment insurance benefits will reduce the unemployment rate, but not by forcing "deadbeats" to go out and get jobs. All else equal, a reduction in benefits should reduce job searches (as workers will be less inclined to hold out for a better job offer). However, many discouraged workers will drop out of the labor force, and no longer considered "unemployed."



The pace of job growth appears to be moderate (although figures over the last couple of years will be set somewhat lower in annual benchmark revisions, due in early February). Private-sector payrolls rose by 159,000 in the advance estimate for October, a 134,000 average over the last three months. That's enough to keep pace with the growth in the working-age population, but not enough to push the unemployment rate down. We need to see monthly payroll gains on the order of 200,000 to 300,000 per month for a number of years.

Job destruction appears to be relatively limited. The problem for the labor market is a muted pace of job creation. A rebound in corporate profits has helped fuel business fixed investment, but has not led larger firms to hire new workers. Much of the job growth in an expansion typically comes from small, newer firms. Credit is still tight for these firms. Job growth should improve over time, but the overall economic recovery is likely to remain gradual.

The large amount of slack in the economy puts downward pressure on inflation. Measures of core inflation have continued to drift lower. Ex-food and energy, the Consumer Price Index rose 0.6% over the 12 months ending in October. Higher commodity prices have not fed through much to the consumer level. Wage pressures have been low and strong productivity growth has helped push unit labor costs lower. The labor market is the widest channel for inflation pressures. Inflation expectations have remained relatively low.



Real interest rates matter in the economy. All else equal, lower inflation means higher real rates. Boosting inflation expectations would reduce real rates, stimulating economic growth. That's the basics behind the Fed's November 3 decision to purchase another $600 billion in long-term Treasury securities by the end of 2Q11. The Fed's purchases ($75 billion per month, on top of $35 billion per month in reinvested principal payments from its mortgage portfolio) should keep long-term interest rates low, encouraging bank lending and risk-taking. The Fed's action is not going to jump start the economy, but should help support growth in 2011.

The Fed's policy decision has created a lot of criticism at home and abroad. Some of that criticism is based on a lack of understanding about quantitative easing. It is not "financial heroin," "black magic," or "a hail Mary attempt to get the economy going." We are in a liquidity trap. The overnight lending rate is effectively 0%. The Fed can't lower it any more. People have been thinking about how to get out of a liquidity trap for a long time and quantitative easing (large-scale asset purchases by the Fed) is how it's done.

Certainly, there are risks and uncertainties with quantitative easing, as there is whenever the Fed eases monetary policy. One concern is that the Fed has a limited experience with it. The first round (the purchase of $1.25 trillion in mortgage-backed securities, $200 billion in agency debt, and $300 billion in long-term Treasuries) was very effective in helping to stabilize the financial system. However, there is some doubt about the effectiveness of further efforts now that financial conditions are "more normal." Many fear that the Fed will not be able to remove policy accommodation in time once the economy picks up. However, the Fed has tested a number of ways (reverse repos, time deposits for depository institutions) to drain reserves from the banking system and is confident that these measures will be effective.

Others worry that the Fed's latest round of QE will weaken the dollar and boost commodity prices. Typically, any ease in monetary policy softens the dollar and lifts commodity prices. However, the dollar has actually improved following the Fed's November 3 policy announcement. Commodity prices have risen in all currencies, not just the dollar, partly reflecting expectations of stronger demand from emerging economies, but also likely signaling speculation (as in 2007 -08). Moreover, commodity price inflation is not the same as consumer price inflation. In general, it takes a huge increase in commodity prices to have much of an impact by the time you get to the consumer. The exception is the price of oil, which has a much more immediate impact. However, oil prices increases over the last several years have resulted in more of drag on economic growth than in a boost to the underlying inflation rate.

To many observers, the Fed's action, in combination with large federal budget deficits, looks suspicious. However, monetary policy decisions are made independently of the government's borrowing. Some fear competitive currency devaluations. However, a weaker dollar is an artifact, not the goal, of quantitative easing.

	4Q09	1Q10	2Q10	3Q10	**4Q10**	**1Q11**	**2Q11**	**3Q11**	**4Q11**	2009	**2010**	**2011**	**2012**
GDP (↓ *contributions*)	5.0	3.7	1.7	2.0	**1.5**	**1.8**	**2.4**	**3.2**	**3.4**	-2.6	**2.7**	**2.2**	**3.4**
consumer durables	*-0.1*	*0.6*	*0.5*	*0.4*	***0.4***	***0.3***	***0.3***	***0.3***	***0.3***	*-0.3*	***0.2***	***0.3***	***0.3***
nondurables & services	*0.8*	*0.7*	*1.1*	*1.4*	***1.5***	***1.5***	***1.5***	***1.6***	***1.7***	*-0.5*	***0.7***	***1.5***	***1.7***
bus. fixed investment	*-0.1*	*0.7*	*1.5*	*0.9*	***0.6***	***0.6***	***0.7***	***0.8***	***0.9***	*-2.0*	***0.5***	***0.7***	***0.9***
residential investment	*0.0*	*-0.3*	*0.6*	*-0.8*	***0.2***	***0.2***	***0.3***	***0.4***	***0.4***	*-0.7*	***-0.1***	***0.2***	***0.4***
government	*-0.3*	*-0.3*	*0.8*	*0.7*	***0.1***	***-0.2***	***-0.1***	***0.1***	***0.2***	*0.3*	***0.2***	***0.1***	***0.2***
Domestic Final Sales	0.2	1.3	4.3	2.5	**2.9**	**2.4**	**2.7**	**3.3**	**3.5**	-3.2	**1.9**	**2.9**	**3.5**
exports	*2.6*	*1.3*	*1.1*	*0.6*	***0.7***	***0.7***	***0.7***	***0.7***	***0.7***	*-1.2*	***1.3***	***0.7***	***0.7***
imports	*-0.7*	*-1.6*	*-4.6*	*-2.6*	***-0.9***	***-0.7***	***-0.8***	***-0.8***	***-0.8***	*2.3*	***-2.0***	***-1.3***	***-0.8***
Final Sales	2.1	1.1	0.9	0.6	**2.7**	**2.3**	**2.6**	**3.2**	**3.4**	-2.0	**2.9**	**2.6**	**3.1**
ch. in bus. inventories	*2.8*	*2.6*	*0.8*	*1.4*	***-1.1***	***-0.5***	***-0.2***	***0.0***	***0.0***	*-0.6*	***1.5***	***-0.2***	***0.0***
Unemployment, %	10.0	9.7	9.7	9.6	**9.6**	**9.4**	**9.3**	**9.1**	**8.9**	9.3	**9.6**	**9.2**	**8.4**
NF Payrolls, monthly, th.	-90	87	190	-36	**150**	**140**	**160**	**170**	**190**	-395	**98**	**165**	**223**
Cons. Price Index (3 mo)	2.5	0.9	-1.5	2.7	**1.9**	**1.5**	**1.6**	**1.7**	**1.8**	2.8	**1.0**	**1.6**	**2.0**
excl. food & energy	1.3	-0.2	1.3	0.7	**0.5**	**1.0**	**1.1**	**1.3**	**1.5**	1.8	**0.6**	**1.2**	**1.9**
PCE Price Index (q/q)	2.7	2.1	0.0	1.0	**1.5**	**1.5**	**1.6**	**1.6**	**1.6**	0.2	**1.7**	**1.4**	**1.7**
excl. food & energy	2.1	1.2	1.0	1.1	**1.0**	**1.3**	**1.3**	**1.4**	**1.5**	1.5	**1.2**	**1.2**	**1.6**
Fed Funds Rate, %	0.12	0.13	0.19	0.19	**0.20**	**0.21**	**0.24**	**0.25**	**0.25**	0.16	**0.18**	**0.28**	**0.28**
3-month T-Bill, (bond-eq.)	0.1	0.1	0.1	0.2	**0.2**	**0.2**	**0.2**	**0.2**	**0.3**	0.2	**0.1**	**0.3**	**0.3**
2-year Treasury Note	0.9	0.9	0.9	0.5	**0.4**	**0.9**	**1.5**	**1.9**	**2.1**	1.0	**0.7**	**1.6**	**2.3**
10-year Treasury Note	3.5	3.7	3.5	2.8	**2.7**	**2.7**	**2.9**	**3.3**	**3.5**	3.3	**3.2**	**3.1**	**3.9**

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